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Fiscal Cliff Tax Update- What to Expect in 2013

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Agenda

- Individual Tax Relief
  - Income Taxes
  - Deductions
- Capital Gains, Dividends and Investment
  - Capital Gains
  - Dividends
  - Corporations and Trusts
- Estate and Gift Taxes
  - Transfer Taxes
  - Basis Rules and Reporting Requirements

Individual Income Tax Rates

Individual Income Tax Rates

- The American Taxpayer Relief Act of 2012 makes permanent for 2013 and beyond the lower Bush-era income tax rates for all, except for taxpayers with taxable income above $400,000.
  - $450,000 for married tax payers
  - $425,000 for heads of households

- Income above these levels will be taxed at a 39.6% rate.

Individual Income Tax Rates

- Taxpayers who find themselves within the 39.6% marginal income tax bracket nevertheless also benefit from extension of all Bush-era rates below that level.

- The new law directs that the $450,000/$400,000 beginning of the 39.6% bracket be adjusted for inflation after 2013 based upon the standard formula of Code Sec. 1(f).

Tax Rates for 2013 under The Act

Single Individuals

If taxable income is:	The tax will be:
Not over $8,925	10% of taxable income
Over $8,925 but not over $36,250	$892.50 plus 15% of the excess over $8,925
Over $36,250 but not over $87,850	$4,991.25 plus 25% of the excess over $36,250
Over $87,850 but not over $183,250	$17,891.25 plus 28% of the excess over $187,850
Over $183,250 to $398,350	$44,603.25 plus 33% of the excess over $183,250
Over $398,350 to $400,000	$115,586.25 plus 35% of the excess over $398,350
Over $400,000	$116,163.75 plus 39.6% of the excess over $400,000

Tax Rates for 2013 under The Act

Married Couples Filing Jointly

If taxable income is:	The tax will be:
Not over $17,850	10% of taxable income
Over $17,850 but not over $72,500	$1,785 plus 15% of the excess over $17,850
Over $72,500 but not over $146,400	$9,982.50 plus 25% of the excess over $72,500
Over $146,400 but not over $223,050	$28,457.50 plus 28% of the excess over $146,400
Over $223,050 to $398,350	$49,919.50 plus 33% of the excess over $223,050
Over $398,350 to $450,000	$107,768.50 plus 35% of the excess over $398,350
Over $450,000	$125,846 plus 39.6% of the excess over $450,000

Individual Income Tax Rates

- The new law not only raises the dollar value but also simplifies that proposal by keying the $450,000/$400,000 threshold amounts to bottom-line taxable income.

- Although these rates are now made "permanent," nothing would stop Congress from reconsidering the entire tax rate structure again in the future, as part of overall tax reform or even earlier as debt ceiling negotiations get underway shortly.

Trusts and Estates

- The Act retains the Bush-era tax rates for all bracket levels that apply to trusts and estates, except for the highest rate bracket.

- That top rate increases to 39.6% and applies to what was the entire 35% bracket range and, therefore, begins in 2013 for taxable income in excess of $11,950.

Capital Gains/Dividends Sunsets

- The American Taxpayer Relief Act raises the top rate for long-term capital gains and dividends to 20 percent, up from the Bush-era maximum 15% rate.

- That top rate will apply to the extent that a taxpayer's income exceeds the thresholds set for the 39.6% rate.
  - $400,000 for single filers;
  - $450,000 for joint filers and $425,000 for heads of households

Capital Gains/Dividends Sunsets

- All other taxpayers will continue to enjoy a long-term capital gains and dividends tax at a maximum rate of 15%.
- A zero-percent rate will also continue to apply to long-term capital gains and dividends to the extent income falls below the top of the 15% income tax bracket-for 2013 to be $72,500 for joint filers and $36,250 for singles.
- Qualified dividends for all taxpayers continue to be taxed at long-term capital gains rates, rather than ordinary income tax rates as prior to 2003.

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Caution

- Installment payments received after 2012 are subject to the tax rates for the tax year of the payment, not the year of the sale.

- Thus, the capital gains portion of payments made in 2013 and later is now taxed at the 20% rate for higher-income taxpayers.

Tax on Net Investment Income

Capital Gains/Dividends Sunsets

- Starting in 2013, under the Patient Protection and Affordable Care Act (PPACA), higher income taxpayers must also start paying a 3.8% additional tax on Net Investment Income (NII) to the extent certain threshold amounts of income are exceeded.
  - $200,000 for single filers,
  - $250,000 for joint returns and surviving spouses,
  - $125,000 for married taxpayers filing separately

3.8% Medicare Tax on Investment Income

- The tax equals 3.8% of the lesser of net investment income or the excess of modified adjusted gross income (MAGI) over $250,000 for joint filers or $200,000 for single filers.

- Thresholds are not indexed to inflation, so the tax will affect more taxpayers over time.

Key Points of the New Medicare Tax

- Effectively reinstates the "marriage tax" since the single threshold ($200,000) is not doubled for joint filers, whose threshold is ($250,000).
- Affects income within trusts, which have no threshold comparable to MAGI for individuals
  - Tax is instead applied to the lesser of the trust's undistributed net investment income or the excess of the trust's AGI over the dollar amount at which the highest tax bracket begins.

Key Points of the New Medicare Tax

Investment Income for the Purpose of the 3.8% Tax

Included	Excluded
Interest	Tax-exempt bond interest
Dividends	Qualified retirement plan distributions
Capital gains	Some business income
Annuities	Gain from the sale of a personal residence (if less than §121 exclusion)
Royalties	
Rents	
Some pass-through income	

Key Points of the New Medicare Tax

- Qualified retirement plan distributions will not be included in net investment income, but might be included in MAGI, which could expose other income to the 3.8% tax

- Roth IRAs are not subject to the tax and Roth distributions are not included in MAGI

- Regular IRA distributions are included in MAGI

3.8% Tax on Net Investment Income:
Example 1

- A married couple with substantial investment income, with pre-investment income of $190,000.

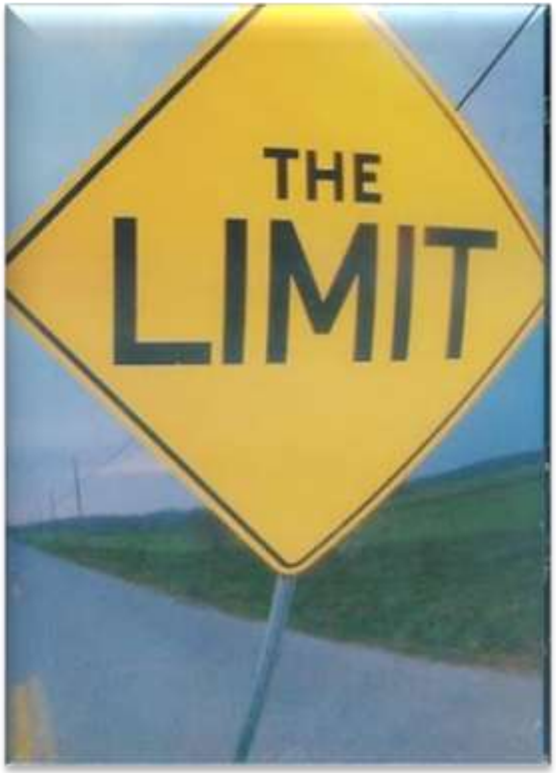
How the 3.8% tax applies	
Interest income (*bonds, CDs)*	$60,000
Dividend income	$75,000
Capital gains	$10,000
Total investment income	$145,000
New AGI	$335,000 *($190,000 + $145,000)*
Excess of AGI over $250,000	$85,000 *($335,000 - $250,000)*
Lesser Amount (*taxable)*	$85,000 *(AGI excess)*
Tax Due	**$3,230** *($85,000 x 0.038)*

3.8% Tax on Net Investment Income: *Example 2*

- An individual with wage income of $85,000, but rents out a small apartment and receives gross rents of $130,000. There are expenses related to this income.

How the 3.8% tax applies	
AGI before rents	$85,000
Gross rents	$130,000
Expenses *(+ depreciation and debt service)*	$110,000
Net rents	$20,000
New AGI	$105,000 *($85,000 + net rents)*
Excess of AGI over $200,000	$0
Lesser Amount (*taxable)*	$0
Tax Due	**$0**

Limitation on Itemized Deductions



Pease Limitation

- The American Taxpayer Relief Act officially revives the "Pease" limitation on itemized deductions.

- However, higher "applicable threshold" levels apply under the new law.
  - $300,000 for married couples and surviving spouses;
  - $275,000 for heads of households;
  - $250,000 for unmarried taxpayers; and
  - $150,000 for married taxpayers filing separately

Impact

The American Taxpayer Relief Act does not call for a full revival of the Pease limitation at former levels.

Pease Limitation

- The dollar amounts are adjusted for inflation for tax years after 2013.
- The Pease limitation reduces the total amount of a higher-income taxpayer’s otherwise allowable itemized deductions by three percent of the amount by which the taxpayer’s adjusted gross income exceeds an applicable threshold.
- However, the amount of itemized deductions is not reduced by more than 80 percent.
- Certain items, such as medical expenses, investment interest, and casualty, theft or wagering losses, are excluded.

Personal Exemption Phase-Out

- The American Taxpayer Relief Act also officially revives the personal exemption phase-out rules, but at applicable adjusted gross income threshold levels slightly higher than in the past
  - $300,000 for married couples and surviving spouses;
  - $275,000 for heads of households;
  - $250,000 for unmarried taxpayers; and
  - $150,000 for married taxpayers filing separately

Personal Exemption Phase-Out

Under the phase-out, the total amount of exemptions that may be claimed by a taxpayer is reduced by two percent for each $2,500, or portion thereof (2% for each $1,250 for married couples filing separate returns) by which the taxpayer's adjusted gross income exceeds the applicable threshold level

Federal Estate and Gift taxes

Federal Estate and Gift Taxes

The American Taxpayer Relief Act permanently provides for a maximum federal estate tax rate of 40% with an annually inflation-adjusted $5 million exclusion for estates of decedents dying after December 31, 2012.

Portability

- The American Taxpayer Relief Act makes permanent "portability" between spouses.
- Prior to the permanent extension, portability was only available to the estates of decedents dying after December 31, 2010 and before January 1, 2013.

Impact

Portability allows the estate of a decedent who is survived by a spouse to make a portability election to permit the surviving spouse to apply the decedent's unused exclusion (the deceased spousal unused exclusion amount (DSUE)) to the surviving spouse's own transfers during life and at death.

Gift Tax

The American Taxpayer Relief Act provides 40% tax rate and a unified estate and gift tax exemption of $5 million (inflation adjusted) for gifts made after 2012.

More Individual Extenders

Teacher’s Classroom Expense Deduction

- The American Taxpayer Relief Act extends through 2013 the teacher’s classroom expense deduction.
- The deduction allows primary and secondary education professionals to deduct (above-the-line) qualified expenses up to $250 paid out-of-pocket during the year.
- Qualified expenses must be reduced by any reimbursements.

Exclusion of Cancellation of Indebtedness on Principal Residence

- This provision excludes from income cancellation of mortgage debt on a principal residence of up to $2 million.
- The American Taxpayer Relief Act extends the provision for one year, through 2013.

Transit Benefits

- The American Taxpayer Relief Act extends parity in transit benefits through December 31, 2013.
- These benefits are a tax-free fringe benefit to employees.
- Parity in the exclusion limit expired after 2011.

Mortgage Insurance Premiums

- This provision treats mortgage insurance premiums as deductible interest that is qualified residence interest.
- The American Taxpayer Relief Act extends this provision through December 31, 2013.
- The provision originally expired after 2011.

Contribution of Capital Gains Real Property for Conservation

- The Act extends for two years, through December 31, 2013, the special rule for contributions of capital gain real property for conservation purposes.
- The special rule allows the contribution to be taken against 50 percent of the contribution base.
- The Act also extends for two years the special rules for contributions by certain corporate farmers and ranchers.

IRA Distributions to Charity

The American Tax Relief Act extends for two years, through December 31, 2013, the provision allowing tax-free distributions from individual retirement accounts to public charities, by individuals age 70½ or older, up to a maximum of $100,000 per tax payer per year.

Impact

- The Act provides special transition rules
  - One rule allows taxpayers to characterize distributions made in January 2013 as made on December 31, 2012.
  - The other rule permits taxpayers to treat a distribution from the IRA to the taxpayer made in December 2012 as a charitable distribution, if transferred to charity before February 1, 2013.

Business Tax Provisions

Code Sec. 179
Small-Business Expensing

- The American Taxpayer Relief Act extends through 2013 enhanced Code Sec. 179 small-business expensing.
- The Code Sec. 179 dollar limit for tax years 2012 and 2013 is $500,000 with a $2 million investment limit.
- The rule allowing off-the-shelf computer software is also extended.

Business Depreciation

- The American Taxpayer Relief Act extends 50% bonus depreciation through 2013.

- Some transportation and longer period production property is eligible for 50% bonus depreciation through 2014.

Impact

Bonus depreciation also relates to the vehicle depreciation dollar limits under Code Sec. 280F, which imposes dollar limitations on the depreciation deduction for the year in which a taxpayer places a passenger automobile in service within a business, and for each succeeding year.

Business Depreciation

- To be eligible for bonus depreciation, qualified property must be depreciable under the Modified Accelerated Cost Recovery System (MACRS) and have a recovery period of 20 years or less

- The property must be new and placed in service before January 1, 2014 (January 1, 2015 for certain longer production period property and certain transportation property)

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Questions & Answers

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